BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 90A-0127-MC
WILLIAM AND MARGARET CRINKLAW	)	

For Appellants: Ronald H. Pacheco
Certified Public Accountant

For Respondent: A. Kent Summers
Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of William and Margaret Crinklaw against a proposed assessment of additional personal income tax and penalties in the total amount of $25,080.35 for the year 1985.

[1/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The issues to be decided in this appeal are (1) whether appellants are entitled to a capital loss carryforward from 1983 related to the worthlessness of qualified and nonqualified retains allocated to appellants by a grower cooperative, (2) whether appellants realized income on the transfer of their farm property to the lender pursuant to a deed in lieu of foreclosure, and (3) whether imposition of the failure to file penalty was proper.

Appellants were farmers who lost substantial amounts of money between 1975 and 1985 and, consequently, they incurred substantial debt. During 1985, appellants apparently faced foreclosure or other creditor action with respect to their farm, and, apparently to avoid foreclosure, they deeded the farm back to the lender. This transaction generated a substantial gain, and although no regular tax was owed because of farming losses, a large preference tax was generated. The predominant dispute in this appeal is whether appellants have a capital loss carryforward from events occurring in 1983.

Appellants were members of California Canners and Growers Cooperative ("CCG"), a nonprofit agricultural processing and marketing cooperative. Over the years, appellants had been allocated both qualified and nonqualified participation certificates, and, as of 1983, they had unpaid retains of $241,389.37.[2/] During 1983, CCG filed a Chapter 11 bankruptcy petition. Appellants treated the participation certificates as equity, and deducted the loss resulting from the bankruptcy as a capital loss. Appellants then sought to carry forward the capital loss to offset the foreclosure gain incurred in the current year.[3/]

The first question is whether the 1983 loss[4/] from the worthlessness of the participation certificates was capital or ordinary. If the loss is considered ordinary, then to the extent the loss exceeded appellants' other income, appellants would have a net operating loss. Pursuant to section 17276, the net operating loss could not be carried forward to offset any income for 1985. However, if the loss is considered a capital loss, then pursuant to section 18152, subdivision (d), appellants would be entitled to carry forward the loss and offset capital gain income in 1985. Appellants contend that the

---

[2/] There is a factual dispute as to the exact amount of unpaid retains. There is no evidence in the record as to the amount of allocations previously included in income (Rev. & Tax Code, § 17086) nor is there evidence as to the amount of cash previously received related to qualified and nonqualified allocations. Respondent has agreed that appellants' basis in the unpaid retains is $241,389.37. Appellants allege it is higher.

[3/] Even if we were to conclude that the loss was capital, we are not sure that this would eliminate any of the current year preference tax. Section 17063, subdivision (e), does not permit the use of the capital loss carryforward for minimum tax purposes.

[4/] The parties have assumed without discussion that the loss on unpaid participation certificates occurred during 1983. While we accept this conclusion for purposes of this appeal, we do not in any way intend to express the opinion that the filing of the Chapter 11 petition was in and of itself sufficient to determine that the participation certificates were worthless. While generally the filing of bankruptcy, especially a Chapter 11, is not itself considered the event fixing the worthlessness of a debt or equity, there are no facts in the record to indicate the actual year the unpaid participation certificates became worthless.

retains were akin to equity, and thus the loss was capital, citing Atwood Grain and Supply Co. v. Commissioner, 60 T.C. 412 (1973). Respondent contends that since the receipt of cash attributable to the retains would have been ordinary income (Treas. Reg. § 1.61-5) and any loss resulting from redemption at less than face value would be ordinary (Rev. Rul. 70-64, 1970-1 C.B. 36; Rev. Rul. 70-407, 1970-2 C.B. 52), then a loss resulting from worthlessness is also ordinary. Respondent also argues that the unpaid participation certificates are not capital assets as defined in I.R.C. section 1221(4).

The concern we have with respondent's reliance on the regulation and revenue rulings is that they are based on federal law. Unlike many other areas of the tax law, California has not conformed to federal law with regard to cooperatives. Instead, pursuant to sections 17086 and 24404, California has a somewhat different scheme than federal law. Federal law specifically states that amounts received on the sale, exchange, or other disposition of nonqualified allocations is ordinary income. (I.R.C. § 1385(c)(2)(C).) California law has no counterpart to this provision. The California statute (Rev. & Tax. Code, § 17086) does not specify the character of the income.

Appellants received two types of retains, qualified and nonqualified. While these are concepts related to cooperative taxation under federal law, the definitions of the terms are useful to determine the state tax consequences. Whether appellants are entitled to an ordinary or capital loss depends on whether the retains are capital or ordinary assets. With regard to the qualified retains, we agree with respondent that these are akin to accounts receivable. Appellants reported $70,323.48 of income on the receipt of qualified participation certificates. Since appellants reported this as income, they have a basis in these certificates of such amount. A qualified participation certificate is defined as a written notice of a stated amount which may be redeemed within a specified time in cash. (I.R.C. § 1388(c).) This sounds like an account receivable, and thus the loss as to this retain is ordinary.

As to the nonqualified participation certificates, the answer is less clear. A nonqualified retain is any written notice of allocation which does not meet the requirements of I.R.C. section 1388(c). (I.R.C. § 1388(d).) I.R.C. section 1221(4) defines capital asset as property held by the taxpayer except "accounts or notes receivable acquired in the ordinary course of trade or business . . . from the sale of property" which would be inventory if held by the taxpayer at the end of the year. The nonqualified retains were received because appellants delivered crops to CCG. We think that if appellants had been in possession of the crops at the end of the year, the crops would have been inventory. Thus, the nonqualified retains were received in exchange for what would have been inventory. Although received for inventory, the participation certificates would be capital assets if they are not like accounts or notes receivable. Therefore, we must consider whether the unpaid participation certificates are more like accounts receivable as contended by respondent or constitute a capital asset in the form of an equity investment as contended by appellants.

An account receivable carries an expectation that the creditor will be paid at some time. Equity implies that the person has put his money at risk for use by the enterprise without any expectation that it will be repaid. Here, there is evidence that the appellants and CCG expected that, at some point in the future, funds would be distributed with respect to the nonqualified certificates.

Documentation of CCG indicated that it had an approximately eight-year cycle of making payments on the participation certificates. Although eight years is a long time to wait to get paid on the typical account receivable, the expectation of repayment clearly existed. There is no evidence that appellants left their funds in CCG via the vehicle of accepting nonqualified participation certificates with the purpose of making an investment. In Atwood Grain and Supply Co. v. Commissioner, supra, cited by appellants, it is clear that the certificates reflected an investment in the cooperative. Such is not the case here. We therefore agree with respondent that the nonqualified retains were like accounts receivable, and thus the loss included was an ordinary loss.

Next, appellants contend that upon the transfer of the farm back to the lender, their amount realized was zero, citing I.R.C. section 108(a)(1)(B), and Treasury regulations pursuant to I.R.C. sections 61, 108, and 1001. They thus conclude their gain was zero. This is incorrect. The appellants' debt was not discharged. Instead, they transferred the farm in exchange for cancellation of their outstanding liabilities. In an exchange, the amount realized includes the liabilities the transferor is relieved of as a result of the exchange. (Treas. Reg. § 1.1001-2(a)(1).) Consequently, respondent properly determined appellants' amount realized on the deed in lieu of foreclosure.[5/]

With respect to the late filing penalty, appellants have offered no explanation for the late filing. Thus, imposition of the late filing penalty must be sustained.

Accordingly, respondent's action in this matter will be sustained.

[5/] It appears from the record that the amount of debt owed on the property was in excess of the amount treated as an amount realized. Either the excess was treated as a discharge of debt, which would be excluded from income pursuant to I.R.C. section 108 or the amount realized was understated. In either event, respondent recognizes that the deficiency is limited to its proposed assessment.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of William and Margaret Crinklaw against a proposed assessment of additional personal income tax and penalties in the total amount of $25,080.35 for the year 1985 be and the same is hereby sustained.

Done at Sacramento, California, this 23rd day of April, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Fong, and Ms. Scott present.

Brad Sherman, Chairman

Ernest J. Dronenburg, Jr., Member

Matthew K. Fong, Member

Windie Scott*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

crinklaw.mc